UNDERSTANDING DONOR-ADVISED FUNDS

THE ULTIMATE GUIDE TO DONOR-ADVISED FUNDS

WH Cornerstone Investments

Choosing to invest in donor-advised funds: thinking it through carefully

Donor-advised funds seem to have come out of nowhere, springing into everyone's consciousness in the past few years. Yet they've been around since the mid-1930s, mostly in community foundations and Jewish federations. The national programs based on these funds emerged in the 1990s.

Today they are the fastest-growing form of philanthropy. Their 2018 grants to charities of $23.4 billion still only made up 12% of individual giving. But contributions to funds grew by over 20% that year, and their accumulated assets reached over $120 billion. (Consumer Reports)

Despite the ballooning numbers in the last decade or so, what seemed to raise the visibility of donor-advised funds with the general public was doubling the standard income tax deduction in 2018. That effectively eliminated many Americans' need to itemize deductions at the same time that many deductions went away.

Suddenly it was harder to write off charitable contributions. (In 2022, for example, you'll have to have enough other deductions to take you above $12,950 for a single taxpayer and $25,900 for a married couple filing jointly.)

What role does charity play?

The U.S. relies a lot on charity to help feed and house the poor.

Charity contributions also fund scholarships and finance cultural efforts such as museums and orchestras. In other countries, these things are supported by governments, thanks to tax revenues. In the U.S., the government provides incentives to donors as tax breaks on their income.

And it's not just the wealthy who support charitable causes. The individual American citizen plays a surprising role. In fact, foundations account for only 15% of charitable giving in the U.S., and corporations account for 5%. The rest comes from individuals, at a rate of $2,600 per household. (Philanthropy Roundtable)

So individual Americans – givers by nature – seek ways to donate and still get a tax deduction.

What makes donor-advised funds attractive?

As December approaches each year, the charitable appeals build up in your inbox and fill your voice mail. You likely have funds you want to contribute, but perhaps not the time to research all your options. You certainly don't want to give your money to groups that misrepresent their intentions or are poorly run.

One potential solution could be a donor-advised fund.

A donor-advised fund is the equivalent of a charitable savings account where you can donate without having to specify the charity that will receive your contribution. You can choose that later. That allows you to front-load multiple years of giving (also called "bunching") and receive the deduction during that current year. Then you make grants to your chosen charities in the following years. While the money remains in the account awaiting distribution, it can be invested and grow tax-free.

Donor-advised funds have indeed grown in popularity. According to the National Philanthropic Trust, the number of such accounts increased by 300% between 2010 and 2018. Grants from funds to charities more than tripled from $7 billion to nearly $23.5 billion in the same time frame (Bloomberg).

Because these funds are easy to set up and flexible, they are attractive to people of all means, not just high-net-worth individuals. Funds are offered by various types of organizations with varying minimum requirements – offering something for everyone. (Some sponsors allow contributions as small as $5,000 and will pay out grants – which can be made anonymously – as small as $50.) They typically charge administrative fees less than 1% for the service.

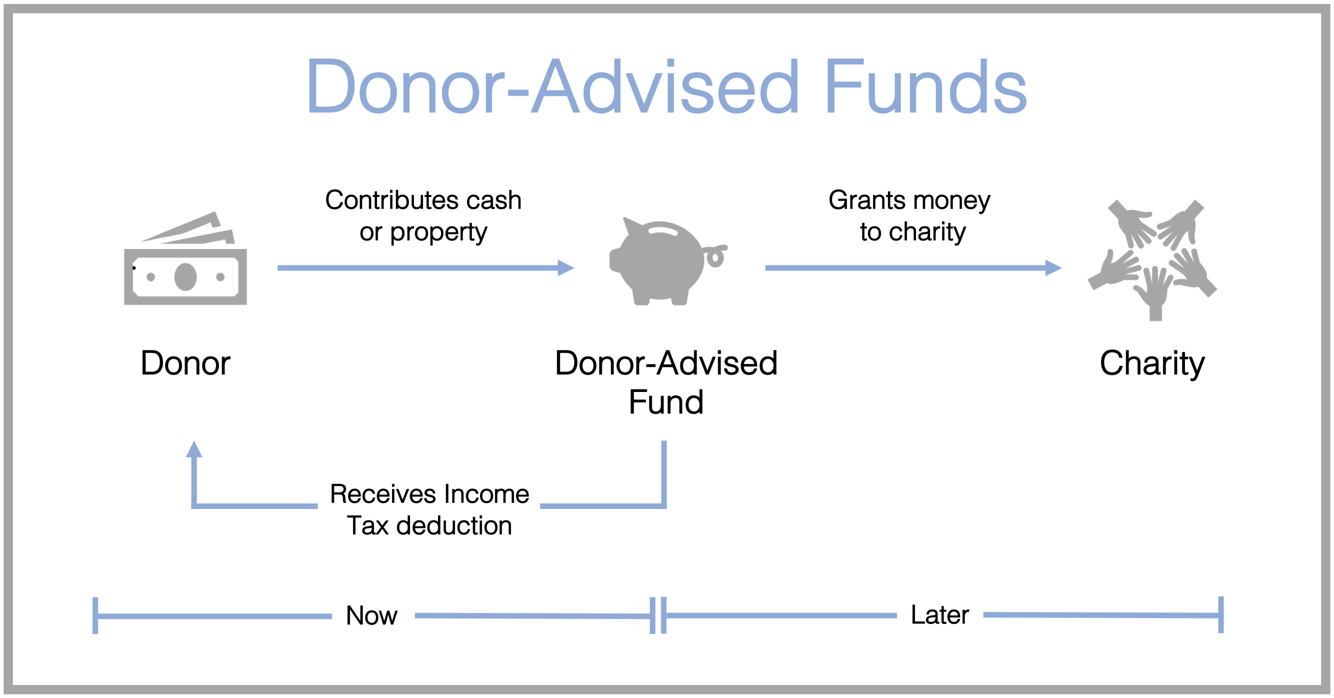
One downside is that there is no central resource to evaluate donor-advised funds. You'll have to do your own research.

On the following pages, we will explore

- How donor-advised funds work;
- What's good about them;
- And what to think about as you decide to participate in one.

How do donor-advised funds work?

In their simplest definition, some call donor-advised funds “your own little charity.” You put money or assets into a donor-advised fund as one-way, irrevocable contributions, appreciated stock, rental property, land, etc. You receive the benefit of income tax deductions immediately. Some sponsoring organization – also called a charitable sponsor – manages your fund. Then, at the pace of your choosing, you recommend grants out of the fund to the qualified charities you select.



We usually think of our tax-deductible contributions going directly to the final nonprofit entity that will use our gift for their programs. Instead, the contribution stays with the sponsoring organization, which could be a:

- community foundation,
- single-issue charity, or
- national charity.

These three options are described in greater detail later, where you will want to decide what kind of sponsoring organization to pursue based on their services, fees and restrictions.

What is a sponsoring organization?

The sponsoring organization must itself be maintained and operated as a section 501(c)(3) tax-exempt, nonprofit organization. Once the organization accepts your contribution, it has legal control over it. You do retain two rights: (1) the advisory privilege regarding when and where the funds will be distributed, and (2) how the funds will be invested while they're waiting for distribution.

But there is no legal requirement of when funds must be distributed. According to the National Philanthropic Trust, in 2018, only 20.9% of contributions were distributed, which means the balance was locked away in the sponsoring organizations (National Philanthropic Trust).

Investing the waiting funds could potentially increase the account's value. However, like any investment, the funds will be subject to market performance. If you lose money, any decrease will only affect what's available to donate. It won't affect your tax deductions, which you already took when contributing to the sponsoring organization.

You will probably want to take a diversified investment approach with your funds. You'll want to rebalance them periodically to maintain the most appropriate risk level over time – just as you would with any investment in a retirement portfolio, for example. Investment assistance is a service the sponsoring organization may offer.

Five investment considerations

Your decision-making process naturally starts with a charitable intent: the desire to make a difference with a contribution. But you'll also want to make the best possible financial transaction. That could be what leads you to look beyond just writing a check to one of your favorite charities.

The following five reasons may lead you to donor-advised funds:

Timing – You can write a check to a charity at any time during the year. But, as mentioned, a donor-advised fund makes sense if you want to get a tax deduction this year without having to distribute funds right away.

Ease – Your role in operating a donor-advised fund is no more complicated than managing a checking account. Depending on the amount you contribute, the sponsoring organization will do most of the work. It will handle any tax-filing requirements. It will propose several investment options for you to choose from, so your balance can grow while waiting to be distributed. If your contribution includes assets (such as real estate or publicly traded or privately held shares), and if it is large enough, an investment manager may even be hired to manage them.

Taxes – As long as you exceed the amount of the standard deduction ($12,550 for singles and $25,100 for couples), the donations you make to qualified charities can be itemized deductions. You can use donor-advised funds as an effective tax strategy to offset taxes in high-income years. They're also useful to avoid the capital gains taxes associated with the sale of low-basis securities: you can contribute the securities to a fund instead of selling them and giving the charity cash. Your tax advisor can help you with deduction rates and limits under a donor-advised fund.

Legacy – A donor-advised fund can serve as a lower-cost private (and non-operating) family foundation. The entire family can participate in recommending organizations that align with family values. The decisions on actual grants can form the basis for the family's charitable legacy.

Planning – Naming a donor-advised fund provides more flexibility than if you designate charities in your estate planning as beneficiaries. As circumstances – or priorities – change, updating a donor-advised fund's grantees is easier than altering estate documents. The involvement of a sponsoring organization also ensures that designated charities continue to be qualified recipients.

How to choose?

There are three key steps to aid your decision-making:

Step One – The first step is to have total clarity on what you are trying to achieve with your charitable efforts and what factors you see as essential. These nine factors will help you do that.

Step Two – Once you have clearly defined what is important to you, review the three different types of sponsoring organizations and select the one you think will best suit your needs. Consider the three types: Community Foundation, Single-Issue Charity, National Charity

Step Three – Perhaps with an advisor's help, identify a minimum of three candidates for the sponsoring organization you want to work with to fulfill your intentions around charitable donations.

Step One: Nine key factors

Step One: The first step is to have total clarity on what you are trying to achieve with your charitable efforts and what factors you see as essential.

These nine factors and question prompts will help you do that:

1. Assets to be donated

- What assets do you want to donate? (Those might include cash equivalents, publicly traded securities or mutual fund shares, restricted stocks, bitcoin and other cryptocurrencies, real estate, life insurance, private equity and certain complex assets such as privately held C-corporation and S-corporation shares.)
- Can your targeted donor-advised fund handle them?
- Will the fund hold them, or do they require an immediate sale?

Step One: Nine key factors (cont'd)

2. Grants to be made

- What causes or charities do you want to support? Many national sponsors allow grants to nearly all Internal Revenue Code Section 501(c)(3) organizations, but some local, single-issue or religious sponsors may have restrictions.
- Do you want to pick who receives your grants or let the fund's managers decide?

3. Ease of transfer

- While funds can't be returned, how easy is it to transfer your account from one sponsor to another?
- Is it an option if you want more investment flexibility?
- Or if you want to support a charity that the sponsor won't approve?

4. Investment options

- What investment options are open to you with the fund, and at what contribution level?
- Only pooled funds?
- Or can you determine the investments?

5. Succession issues

- How is succession handled?
- Can you name a successor donor advisor to continue your giving after your death?
- Or do the assets revert to the sponsoring organization?

6. Value of grants

- How free are you to determine how much to give each year? Does the fund decide?

7. Timing of setup

- What are the deadlines for yearend contributions to the fund?
- How much time is needed to open and fund an account?
- And how long does it take to process a grant request?

Step One: Nine key factors (cont'd)

8. Costs

- How much are you willing to pay as an administrative fee? (They vary by the sponsor and go down noticeably as the size of your account increases.)
- What about investment fees? (These are similar to those you would face in any other investment account.)

9. Grant-making process

- Can you complete the grant-making process online, or only by phone or in person?
- Will you deal with a call center or an assigned human being?
- Can you schedule grants in advance, say monthly, quarterly or yearly?

Step Two: three types of sponsoring organizations

Step Two: Once you have clearly defined what is important to you, review the three different types of sponsoring organizations and select the one you think will best suit your needs.

Consider the three types: community foundation, single-issue charity, national charity.

COMMUNITY FOUNDATION	SINGLE-ISSUE CHARITY	NATIONAL CHARITY
An independent, noncommercial tax-exempt organization that raises funds from the public and usually addresses the community's needs in a specific geographic area, typically no larger than a state. Being deeply rooted in a location, it has the advantage of understanding local needs and connecting donors who have diverse interests to local charities. However, it may not accept complex assets and may be more limited in online capabilities.	Include faith-based organizations (such as Catholic community foundations or Jewish federations), universities, Rotary foundations and issue-specific nonprofits. These tax-exempt organizations tend to work in a specific topic area, such as the environment, social justice or international relief, or with specific groups of people. You will find kindred spirits active in these organizations, and they may have the highest grant payout rate (nearly 30%).	Charity exists solely to sponsor donor-advised funds. Nationally focused and may be a commercial gift fund (the charitable arm of a large institution (such as Schwab, Fidelity or Vanguard) or an independent noncommercial organization (such as National Philanthropic Trust). These are the fastestgrowing type of sponsor organization. They may not be focused on any specific cause that's important to you. However, they may offer employer-sponsored workplace giving and employer matching.

Source: National Center for Family Philanthropy

Step Three: identify candidates

Step Three: With an advisor's help, identify a minimum of three candidates for the sponsoring organization you want to work with to fulfill your intentions around charitable donations.

Once the organizations are identified, it's time to research what each one charges in administrative fees, investment fees and other factors.

Combine this cost information with how you think the organization will fulfill the factors you identified in Step One. With this information, you should be able to identify the preferred choice of sponsoring organization for your donor-advised funds.

Donor-Advised Fund	Fund Choice A, B, C
Sponsoring charity's website URL	
Minimum starting balance	
Administrative fee: • ≤\$500,000 = • \$500,000 - \$1M = • \$1M - \$2.5M = • \$2.5M - \$5M = • >\$5M =	
Investment fee for your selected type of investment	

Note: Donor-advised funds often carry hidden fees that donors are unaware of, much as you find with 401(k) plans. Consider investigating this issue further before selecting a fund.

Selecting an investment

First, it's essential to know if using a donor-advised fund is necessary for your giving. Can you just as easily give to a nonprofit without one? What is the cost, and what is the benefit of using a donor-advised fund?

If you are under time pressure to contribute – to capture the tax deduction – but you don't have a nonprofit in mind, choose a sponsoring organization with intention. Choose one that will help you achieve your charitable giving in a way that matches your goals and values. (Community foundations and single-issue charities may prove more helpful in the nonprofitselection process.)

If you have appreciated securities or other tangible assets to contribute, and the charities you want to support cannot receive them, use a donor-advised fund to bridge that gap. By using a fund and avoiding having to pay the capital gains tax on the sale of any assets held for over one year, you'll increase the amount you have available to grant.

Consider giving away your funds timely, unless accumulating them is part of a specific strategy. Maybe the funds are intended for use in a natural disaster. Or maybe a large, multi-year contribution will better meet the nonprofit's needs, such as in the case of an endowment. Or lastly, if it's part of a teaching tool about family philanthropy, seek a balance between that purpose and the needs of the nonprofits you want to support.

We are here to help.

Do you want to understand more about donor-advised funds? In the end, the goal is to maximize the ultimate value to those you aim to help and bring you the greatest joy.

For more specific advice on meeting your personal charitable giving goals, talk to us.

Learn more at www.whcornerstone.com.

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